

**A CRITICAL ANALYSIS OF RECENT
FORMULATIONS OF ACCOUNTING PRINCIPLES**

BY

LESLIE JAMES BUCHAN

B.S., University of Illinois, 1922

M.S., University of Illinois, 1923

AN ABSTRACT OF A THESIS

**SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN
ACCOUNTANCY IN THE GRADUATE SCHOOL
OF THE UNIVERSITY OF ILLINOIS, 1943**

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A CRITICAL ANALYSIS OF RECENT FORMULATIONS OF ACCOUNTING PRINCIPLES

Accounting, specifically in its public reporting aspects, has often been characterized as "a universal language." As such it conveys information on economic enterprises from one person or group to other interested persons. If it operates perfectly, as languages seldom do, the information conveyed is complete and true. If, though, there is lack of understanding of its symbols or concepts either by those who prepare reports or those who read them the information conveyed is incomplete and blurred, if not false.

Since accounting is a language of economic intercourse, the responsibility resting upon those who use it and the demands upon it change with the evolution of the economic system. The recent rapid development of the corporate form of enterprise operation with the concomitant increases in the complexity of financial relationships and the number of individuals served by accounting reports has focused attention upon the need for a reexamination of the principles under which both the new responsibility and the new demands are to be met. The first step in such a program is to determine whether the principles followed convey the clearest possible picture of the more complicated situations. The second step is to educate the new readers and the old in the principles employed. The recent attempts to enunciate precise formulations of principles of accounting represent the beginning of this reexamination.

It is the purpose of this thesis to compare and analyze critically the most significant of them to determine possible bases for reconciliation of conflicting views and, in addition, to test the desirability of accepting even those principles in which there may be agreement among the formulations.

The following publications were chosen for special study.

1. *Audit of Corporate Accounts.* A pamphlet of the American Institute of Accountants containing the correspondence between its Special Committee on Cooperation with the Stock Exchanges and the Committee

on Stock List of the New York Stock Exchange, January 21, 1934.

2. *Reports to Stockholders*. A report of the Committee on Statistical Reporting and Uniform Accounting for Industry to the Business Advisory and Planning Council for the Department of Commerce, published by the United States Government Printing Office, Washington, August 2, 1934. Republished in the *Accounting Review*, September, 1934, pp. 201-219.
3. *A Tentative Statement of Accounting Principles Affecting Corporate Reports*, by the Executive Committee of the American Accounting Association, *Accounting Review*, June 1936, pp. 187-191.
4. *A Statement of Accounting Principles*, by Sanders, Hatfield and Moore, Pamphlet of the American Institute of Accountants, January, 1938.
5. *An Introduction to Corporate Accounting Standards*, by Paton and Littleton, Monograph No. 3, American Accounting Association, January, 1940.

They were selected because each of them represents a joint attempt to enunciate principles of accounting for profit making corporations even though it was recognized in making the selection that they are not completely comparable because of the different areas covered by them.

Direct comparison of the formulations, to the extent possible, revealed certain general areas of disagreement among them which were then subjected to further investigation. The current literature of the period just before and since their formulation was studied intensively both in arriving at the real areas of disagreement and in attempting to find a method of reconciling the differences, when discovered. In addition to this, full advantage was taken of every opportunity to hear the discussion of accounting principles in numerous meetings and in interviews with individuals. These individual discussions proved exceptionally valuable in this respect because they afforded an opportunity to determine the reasoning back of the individual's preference. This is important because the greatest hope for reconciliation of opposing views as to prin-

ciples rests in reconciliation of this underlying reasoning. Of the conclusions drawn from this study, space here will permit the showing only of those in which discussion of the issues appears to offer the greatest hope for further improvement of the formulation. These may be summarized as follows:

1. They all fail to define the function of accounting to be accomplished by the principles narrowly enough to make the reports, prepared in accordance therewith, of maximum service to those persons who alone are served by published reports, i.e., creditors and stockholders, present and prospective.
2. They generally agree that the information to be furnished should consist of income statements, balance sheets and analyses of surplus, but in doing so they err in assuming that the so-called income statement can be made to show *income* in any very real sense.
3. They are inclined to limit the amount of information, to be supplied, to these formal statements with only random suggestions for supplying information of value in interpreting them so as to approximate income.
4. They give almost no consideration to the possibility of providing that these basic statements be supported by *required* interpretive information.
5. Although they agree in general that the basic statements should be based primarily upon cost they all allow valuations to be injected into them unnecessarily at times. The impulse to do so might be avoided almost entirely by providing that the same valuations must be given as interpretative information.
6. They all exhibit a strong tendency to substitute legal reasoning for accounting reasoning.
7. Many principles in several of them are stated as though they were intended as guides to public accountants rather than as principles of reporting to be followed by the management.
8. None of the formulations treats adequately of the principles of reporting transactions which are not between independent parties.

9. Likewise, none of the formulations treats adequately of the principles of reporting transactions which are not completed on a monetary basis. In addition, some of the formulations classify certain non-monetary transactions as donations, although they have no important characteristics of donations. As a consequence of this confusion, the principles drawn in terms of "donations" are acceptable neither for these transactions nor for those representing the extremely rare cases of genuine donations in corporate affairs.
10. Certain general accounting propositions need more intensive study than has been given in the formulations. Some of these are:
 - a. The formulations recognize that the purchasing power of the monetary unit changes but none of them requires that any interpretative information be furnished to the reader to enable him to estimate its over-all effect upon the enterprise.
 - b. The subjects of interest on owned capital and interest as a cost of production are inadequately treated in the formulations.
 - c. Probably because of the failure to deal decisively with the subject of interest as a cost of production, the propositions covering interest on borrowed capital are unsatisfactory.
 - d. All of the formulations, in relating income of the corporation to income of the stockholder, accept the legal entity fiction (under which it is assumed that the latter receives no income until assets are severed from the corporate properties and that he recognizes losses only by valuation or upon liquidation of his interest) as controlling in in most cases. It has, however, been concluded here that, for the purpose envisioned in this study, the association fiction (under which it is assumed that the stockholder recognizes his prorata share of the corporate income or loss when it is recognized by the corporation) is preferable.
 - e. As a result of the adoption of the entity fiction the formulations undertake to maintain a record of undistributed profits but none fulfills this obligation. This failure is due

in no small measure to their common attempt to classify the stockholders' equity section under a single classification as between capital and earned surplus. Unfortunately, they do not define these terms consistently since at times capital is made to show that part of the equity which is legally restricted as to distribution, and at other times it is defined as the sum received from stockholders. (Even in this latter case they err in including sums from stockholders who have retired, and, therefore, as a measure of the investment of present stockholders—or as a measure of their predecessors' investment when they acquired their interest outside of the corporation—the term is of dubious significance.) Surplus, on the other hand, under the first definition of capital above usually means that part of the equity which is legally unrestricted as to distribution, while under the second definition of capital, surplus means sums not received from stockholders. (Here again, the term stockholder includes all stockholders, even those who have retired, so that this sum is of doubtful importance to present and prospective stockholders.)

Since dividend distributions (which distributions are not limited to undistributed earnings) mark the time of recognition of income by the stockholder under this theory, the single classification provided by the formulations is so unduly influenced by corporate law as to make it valueless as a statement purporting to maintain a record of undistributed earnings. Some of the formulations, when faced with this conflict between that which may be legally distributed as dividends and that which represents undistributed earnings, adopt an almost purely legalistic division as between capital and surplus. At least one of them blames the law for the fact that the legally distributable portion is not limited to undistributed earnings. It is suggested here that a more fruitful approach to this problem can be made by insisting upon a double classification of the stockholders' equity, one showing it as to legal restriction, and another showing it classified as to source. This suggestion is made notwithstanding the belief that

the entity fiction is not as desirable in this area as is the association fiction. It is not as desirable because under it the income of stockholders loses time significance, it does not provide for prompt recognition of objectively determined losses, and, due to the fact that assets are severed, it suggests a greater certainty of income than is justified by the facts, since under either fiction the sole test of the reality of income rests upon the same income statements and not upon asset severance.

- f. If the association fiction were adopted a classification of the stockholders' equity section as to legal restriction alone would be necessary, since the stockholder would recognize his income and *losses* when the corporation recognized them. However, greater care in the preparation of income statements would be required if the stockholder were to accept this fiction.
- 11. Those formulations which are complete enough to touch upon the problems created by periodicity to an appreciable extent appear to accept the proposition that formal income calculation is for the most part a process of matching costs and revenues, and in the process it is assumed that the enterprise is—in the absence of evidence to the contrary—a going concern, that the report is for a definite period shorter than its full life cycle, and that the current report is only one of a continuous series of reports to be rendered. In the application of this proposition and the assumptions there is some lack of agreement between the formulations and they are subject to some criticism even in areas in which there is apparent agreement. These areas may be summarized as follows:
 - a. When two or more services of separate significance to the enterprise are acquired in the same transaction the formulations offer no satisfactory suggestion as to the basis upon which the transaction price should be divided. Furthermore they make no requirement that the basis for the division actually performed be disclosed to the reader so that he may test its soundness.
 - b. When one service is acquired through a series of transac-

tions there is general agreement that the separate transaction amounts should be combined to represent the cost of the service acquired. An application of this principle in which interest paid during the construction period is added to the cost of construction is questioned here, because it is felt that this is an incomplete and haphazard application of the principle that interest is a cost of production and furthermore that the contractual interest paid is not the interest which is such a cost.

- c. Differences between the formulations as to original classification of costs arise to a large extent from the difference in beliefs as to what the statements are expected to show. For instance, some of the formulations provide that pre-paid expenses shall not be included in current assets, apparently on the basis that current assets should be stated on a liquidation rather than a going-concern basis. This is in opposition to the better view apparent in other formulations that inasmuch as these costs will be matched against revenue of the near future they should be combined with other current assets. Also the insistence that equities be stated primarily upon a legal basis rather than by source causes some of the formulations to provide that so-called prepaid interest, particularly bond discount, be shown as a deferred charge on the asset side of the balance sheet instead of being shown in conformity with the better view as a deduction from the face amount of the obligation on the equity side.

A more serious disagreement, as regards its effect upon the income calculation, has to do with the original classification of organization expense and goodwill. One formulation classifies the former as a permanent asset not subject to amortization against income, while at the same time it classifies the latter as a deferred charge to be amortized. Another one makes exactly the opposite classification of these two items. Since the costs incurred in both cases represent services which are not permanent, the conclusion is reached here that both should be classified as deferred charges and regularly amortized on the income

statement.

An original classification of certain costs as intangibles suggested in at least one of the formulations seems meaningless for the accounting purpose visualized in this study.

- d. The position taken upon original classification of items such as organization expense and good will of necessity determines the decision as to their subsequent tracing in the accounts.

The tracing of costs associated with inventories of merchandise involves a decision as to whether the first-in, first-out method of inventory or the last-in, first-out method shall be employed. The conclusion was reached in this study that the first-in, first-out method is more consistent with the basic purpose of matching costs and revenues than is the latter method. The principal justification for the last-in, first-out method, that it tends to state costs and revenues both in terms of the prevailing dollar valuation, is viewed as unconvincing. This is only a partial attempt to eliminate the effect of changing price levels from the accounting structure, the full effect of which may more properly be eliminated by proper interpretation.

The valuation of inventories at cost or market, whichever is lower, is looked upon as an arbitrary injection of valuation into a structure which is otherwise based upon cost, and may be justified otherwise only by assuming a pseudo transaction, under which heading the practice is discussed later.

The subsequent tracing of costs subject to depreciation charges is inadequately provided for in the formulations. They either provide that any method of calculating depreciation is proper if consistently applied, or that the straight-line method is to be preferred. The conclusion is reached here that the production method is the only one which is in conformity with the principle of matching costs and revenues, and that the straight-line basis is justified as an expedient only when it fairly approximates the results of the production basis.

There are important disagreements between the formulations as to the tracing of costs which are reflected in losses. Two of the formulations provide that all such losses (and gains) must be reflected in the current income statement or the statements of past periods must be revised to include them. Others provide that they may be charged (or credited) to earned surplus. For the purpose visualized here neither of these views is believed to be completely acceptable. The first is unacceptable because it is only by injecting interpretation that such losses may be related to past periods. Even if unquestionably related to them, they should be included on the current income statement, so that the reader may have available in one place all recorded changes effected within the period to enable him to revise his continuous estimation of true income accordingly. The second is even less acceptable because it depends upon the same interpretation as the former, but then fails to include the adjustment on any income statement.

- e. Revenue from investments in stocks of other companies is recognized under the entity fiction, rather than in accordance with the association fiction which is believed to be preferable.
 - f. Only one of the formulations takes a positive stand against the prevailing undesirable practice of charging many costs off as incurred, rather than matching costs and revenues.
12. The formulations are either in disagreement with each other or subject to criticism as they treat of financial transactions in which property is received by the reporting company. Instances of these cases are as follows:
- a. They treat inadequately of the problem of dividing a transaction in which two different equities are created.
 - b. Their failure to classify equities both as to source and separately as to legal characteristics brings about such widespread disagreement between them as to the equities section of the balance sheet that it seems impossible to reconcile them without requiring the double showing.
13. Financial transactions in which assets are assigned by the reporting enterprise give rise to the greatest amount of

disagreement between the formulations as well as the greatest criticism in this study. Examples of each are given below:

- a. Since they attempt to show only one classification of equities, there is an inevitable conflict between those which insist upon showing the legal result of a transaction and those which would show the effect upon the statement as an accounting representation of equities by source.
- b. The formulations are to be criticized for including in the term "stockholders" even those stockholders who have retired.
- c. The formulations without exception look upon a transaction in which a corporation "reacquires" an equity in exchange for assets as resulting in the acquisition of a quasi-asset when the equity may be reissued. This they do even when they take a positive stand that "treasury stock" is not an asset. This assumption is subject to serious challenge.
- d. They uniformly assume that equities may be divorced from the assets which give them substance, and therefore that the quasi-asset acquired is properly represented in the accounting structure at its cost until disposition is made of it. This assumption, however, leads to the conclusion that when an equity is reacquired there is no obligation to remove from both the asset and equity showing the full historical representation of the original equity. To avoid the fact that such treatment leaves in the asset amount a sum not paid in by remaining equity holders, a theory of "donation" is invented under which it is held that if less than recorded amount is paid in cancellation of the equity the former equity holder makes a "donation" to the remaining holders and if more is paid the "donation" is by the remaining stockholders. This reasoning has been designated as the "quasi-asset assumption" here but has been rejected as being unrealistic on account of the ludicrous results it produces in most cases.

If, on the other hand, the asset and equity representation of the original equity showing are both removed from

the accounting structure at their original amount as they should be, the results are entirely realistic. Thus, in case the equity is cancelled at less than its recorded amount, there must be an adjustment in the recorded asset amount equal to this reduction. Since it is usually not feasible to identify the original asset so as to reduce its historical showing, and since it would be undesirable to do so if it were possible (because this would upset the regular matching of original cost against revenue), this amount must be deducted from the total asset amount. In this way the individual assets would show unamortized historical amount, but the total would be reduced to cost to present equity-holders. This view has been urged here under the designation of "the liquidation assumption" as basic in all such equity transactions. It is believed that it should be adhered to in the absence of unmistakable proof that the asset values did not enter the mind of the retiring equity holder, as in some instances when equities are cancelled during a panic. In that event the quasi-asset assumption might be looked upon as a recognized departure from standard practice.

- e. The formulations erroneously draw an accounting distinction between equities reacquired for cancellation and those reacquired but which may subsequently be reissued.
- f. The formulations all accept the proposition that an equity is represented in the accounting structure by its "prorata share" of the total of similar equities. This is often contrary to known facts available at the time it was established and as yet available by adequate record keeping. When transactions are recorded under this assumption, all designations of capital as contributions by stockholders lose their meaning to remaining stockholders.
- g. The formulations exhibit uncertainty as to the concept of income which they envision, especially in regard to recording transactions with equity holders and retiring equity holders. Four possible concepts are evident throughout them but no formulation consistently adheres to any one of them, nor is any attempt made to record successive-

ly the amount under the several concepts. These concepts are designated here as (1) the enterprise concept (in which transactions with only non-equity interests affect income), (2) the total-stock equity concept (in which these transactions and those with creditors affect income), (3) The remaining stock-equity concept (in which these transactions and those with retired equity holders may affect income) and (4) the junior stock-equity concept (in which all of these transactions and those with preferred stock interests may affect income).

- h. The adoption of the total stock-equity concept causes the formulations to provide that interest shall be deducted in arriving at income, but, since no adjustment is made for an amount "accruing" to senior stock issues, the final income figure is not of full significance to junior stockholders. Moreover, even though they also adopt the entity fiction, there is no requirement that dividends on these issues be deducted to arrive at final income.
 - i. The formulations do not treat adequately of the problems of amount which arise when dividends are paid in property other than cash.
14. The formulations recognize many agreements as affecting the accounting structure which do not add to or subtract from the properties of the enterprise. Some of the more important of these are inadequately treated by them, whereas the provisions for reporting others are of doubtful propriety. Instances of each of these are as follows:
- a. Legal reorganization and even an invented situation of "quaisi-reorganization" appear to be accepted as justification for a departure from the historical basis of reports with no requirement that costs on the original basis be provided as interpretive information.
 - b. Refunding operations are discussed almost exclusively in terms of those situations where new securities are issued and old ones retired, in which case there are two distinct transactions. They do not treat separately of the common occurrence of refunding which arises from a revised agreement as to the terms of the original transaction.

- c. Several instances of what have been described here as pseudo transactions are treated in the formulations as genuine accounting transactions with resulting confusion. Typical of these are reductions and increases in stated value of stock, stock dividends, "donation" of stock, deficit absorptions (all of which are purely legal or contractual adjustments and should not be confused with other transactions), statements of inventories on the cost or market, whichever is lower, basis (on the erroneous theory that this period sells the inventory to the next period) and appreciation in the case of discovery (which if recognized results in an unnecessary injection of valuation).
15. Several instances were noted in which two items not wholly similar were combined in one term, and then conclusions applicable to only a part of them were justified as to all of them by reference to the characteristics which made them different. Some of these instances have been touched upon previously in another connection but are repeated below:
- a. Bond discount and expense are combined because both should be amortized against income, but the argument that bond discount should be deducted from the face of an obligation on the balance sheet is not appropriate as regards the expense of selling the bonds.
 - b. Refunding transactions are made to include those cases where new securities are sold and old ones paid-off as well as those in which only an adjustment of the original agreement takes place.
 - c. The term "donation" is perhaps the most seriously abused of all in this respect as has been previously shown.
 - d. Organization expense, it appears, is held by some of the formulations to be a permanent asset because, if the charter fee of a corporation having perpetual existence under the law is included, that fee represents a permanent service.
 - e. It is provided in one formulation that improvement taxes shall be added to land cost, yet a large proportion of such taxes are for improvements not having permanent life, and which, therefore, should be amortized.

VITA

The writer was born at Clarion, Iowa, on March 27, 1901. He was graduated from the Clarion High School in 1918, and in September of that year entered the University of Illinois where he completed the requirements for the degree of Bachelor of Science in Banking and Finance in June, 1922. Following his graduation, he served as an assistant instructor in Accountancy in the College of Commerce until June, 1924. During this same period, he completed the requirements for the degree of Master of Science in Accountancy, and passed the examination and was awarded a certificate as a Certified Public Accountant of Illinois.

He has had professional experience in the Accounting Methods Department of the Southwestern Bell Telephone Company in St. Louis, Missouri, from 1924 to 1925 and in public accounting practice in Miami, Florida, from 1925 to 1930, during which latter period he was successively a junior accountant, a senior accountant, and finally a partner in the firm. On September 1, 1930, he was appointed Professor of Accounting in the College of Commerce and Business Administration of Tulane University, which position he held until he was appointed Dean of that College as of September 1, 1939, a position he holds at the present time.

He has served as a director of the New Orleans Chapter of the National Association of Cost Accountants, as a member of the Committee on Accounting Procedure of the American Institute of Accountants, as Vice President of the American Accounting Association and on numerous committees of the Louisiana Society of Certified Public Accountants.

He is a member of Beta Alpha Psi and Beta Gamma Sigma.

